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SIPDIS

STATE FOR EUR/FO, EUR/SCE, AND EEB/IFD
TREASURY FOR OASIA - JEFF BAKER AND PETER MAIER

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TAGS: [EFIN](#) [ECON](#) [PGOV](#) [SOCI](#) [IMF](#) [IBRD](#) [BK](#)
SUBJECT: BOSNIA: WORLD BANK DEADLINE LOOMS - POTENTIAL
UPHEAVAL AHEAD

REF: A. SARAJEVO 82
[1](#)B. 09 SARAJEVO 1419
[1](#)C. 09 SARAJEVO 1299

Classified By: Econ Counselor Eric Luftman for reasons 1.4 (b) and (d)

Summary

[1](#)1. (SBU) Federation parliamentarians face a February 26 deadline to fix the entity's unsustainable system of social benefits, or risk grave financial and political consequences. At stake are a \$111 million World Bank budget support loan, an IMF disbursement worth \$135 million, ten more IMF disbursements over the next three years, and a 100 million euro EU budget support loan. These losses will translate into cuts of nearly 20 percent across the board in the Federation's 2010 budget, affecting wages, government operations, investments, pensions, and social benefits. The Republika Srpska, though it has met all conditions to date, will share the pain of the Federation's failure, as disbursement of the assistance requires compliance of both entities. Moreover, this will give RS politicians ample reason to push for greater autonomy of the entities. The Embassy and others in the international community have pressed leaders of Federation ruling parties to pass the necessary reforms. Though these leaders seem to be getting the message, their party members in Parliament worry that voting for the reforms will incite veterans whose benefits are most threatened. It remains unclear whether the legislators will do the right thing. End summary.

How Did Bosnia Get into This Hole?

[1](#)2. (SBU) For five years prior to the global financial crisis, when the Bosnian economy was growing at 5-6 percent per year, the entities -- particularly the Federation -- passed a series of overly-generous, poorly-structured, and unfunded social benefits and pension programs, largely to win votes. Extending to both civilian and veterans programs, the result has been a benefits system that is one of the most expensive in Europe. Comparing 25 countries in Central and Eastern Europe and Eurasia, the World Bank has shown that Bosnia and Herzegovina's spending on social assistance, at four percent of its GDP is second only to Croatia's system in cost.

[1](#)3. (SBU) Yet for all the expense, Bosnia's system ranks as the most inequitable among the 25 countries of the region. Only 18 percent of benefits in the Bosnian system reach the poorest fifth of the population, less than what the wealthiest receive. Among veterans, the disparity is even more stark: 27 percent of veteran-related benefits go to the top fifth of veterans, while less than 15 percent go to the bottom fifth.

14. (SBU) The Republika Srpska pursued a similar path of excessive public expenditure but was better able to afford such programs thanks to the trust fund created with the sale of RS Telekom and other state-owned companies. Nevertheless, the RS has eaten through most of the privatization revenues at an alarming rate, and by the spring of 2009, both it and the Federation faced unsustainable budget deficits that led them jointly to apply to the IMF for help.

IMF to the Rescue

15. (SBU) Bosnia signed a Stand-By Arrangement with the IMF worth \$1.6 billion in the summer of 2009, to be paid out over three years in twelve quarterly tranches. The money would be divided between the Federation and RS at a 60/40 ratio. The first tranche, worth about \$275 million, was disbursed in September 2009 upon completion of a number of conditions in both entities, including rebalancing of the 2009 entity and state budgets, and adoption of reforms of state wages.

The World Bank Plays Bad Cop

16. (SBU) Generous though it was, the IMF program wasn't sufficient to plug the entities' anticipated 2010 budget deficits. The Bosnian government therefore negotiated a parallel agreement with the World Bank for a "development policy loan," a budget-support program of \$100 million (later renegotiated to \$111 million) to be fully disbursed in 2010. In return, the Bank set conditions for reform of the social benefits system that went beyond those set by the IMF for

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disbursement of its second tranche, and got more to the root of the problem.

17. (SBU) Seventy percent of the development policy loan is on virtually interest-free "IDA" terms, which will expire on June 2011. The World Bank announced in January that if the Federation did not complete the final conditions for the loan by February 26 -- thirty days before the next meeting of the World Bank board -- it would cancel the loan and reprogram the money.

What Does the Reform Package Require?

18. (SBU) World Bank analysts of Bosnia's entitlements system observe beneficiaries double- and triple-dipping into social programs at the entity, cantonal, and municipal levels, or in some cases drawing from both Bosnian and Croat programs. The main goal of the reforms is introduction of a means-testing mechanism, to be implemented in 2011, and starting with an audit of beneficiaries to clean the records. These programs would exempt anyone with more than a 60 percent disability, and would improve coverage of the poorest citizens, regardless of disability level.

Federation Parliament to PM: Talk to the Vets

19. (SBU) The Federation government adopted all of the required reform legislation and presented it to the House of Representatives for approval in January. But with the fresh memory of veterans' organizations storming the floor of the legislature in November, the legislators refused to act on the package, telling the government to talk to the vets. Prime Minister Mustafa Mujeginovic negotiated with fourteen veterans' associations on February 12-13. Though he claimed to be making headway, the talks ultimately failed. Veterans remind their politicians that the benefits were promised to them, and the parliamentarians remain unwilling to reopen the issue. Meanwhile, other groups are joining the veterans' ranks. The alliance of BiH trade unions has announced that 2500 workers will demonstrate in front of the Federation

Parliament building on February 23, in protest against an IMF-driven law that cut state employees' wages by ten percent.

Giving Dodik the Case for Entity Autonomy

¶10. (SBU) The prospect of losing the IMF and World Bank money particularly rankles the Republika Srpska, which rebalanced its 2010 budget and enacted all the necessary wage and social benefit reforms by December 31. RS officials have questioned why their access to these funds must be shackled to the Federation's failure to straighten out its own finances. In Washington in early February, BiH Prime Minister Nikola Spiric -- an SNSD party ally of RS Prime Minister Miroslav Dodik -- asked the World Bank and IMF to disburse to the RS and withhold from the Federation. Holding to the letter of their agreements with Bosnia, both the IMF and World Bank turned Spiric down.

What Will Happen If the Package Fails?

¶11. (SBU) Completing the necessary reforms will unlock nearly KM one billion in budget support funds for Bosnia, or about \$700 million, in 2010, with a similar amount over the next two years through the later tranches of the IMF program. Divided 60/40, that would be \$420 million for the Federation and \$280 million for the RS. Federation Finance Minister Vjekoslav Bevanda has said that loss of these programs will mean a \$360 million shortfall in the 2010 Federation budget, necessitating an 18.7 percent cut in programs across the board. The alternatives for raising revenues are not attractive. Commercial borrowing would involve much higher rates of interest, and dangerous levels of debt. The Federation has many state enterprises available for privatization, but unloading them under the current circumstances would be a fire sale.

¶12. (SBU) Unlike the World Bank, the IMF has not set an explicit deadline for disbursement of the second tranche. It is possible that Bosnia could lose the World Bank loan, but at some later date meet the conditions needed for disbursement of the IMF money. This would still, however, require deep budget cuts and renegotiation with the IMF on tougher terms. In any scenario other than completion of the

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reforms, confidence of commercial banks and private investors in Bosnia will take a nosedive, and tensions between the two entities will build.

Making a Last Ditch Effort

¶13. (SBU) Within the past week, the IMF and World Bank have raised the volume on the issue, mobilizing the international community. At their urging, the ambassadors of the Peace Implementation Council issued a public letter on February 22 calling on the Federation government and legislature to pass the reforms to try to give the local politicians some needed political cover.

¶14. (SBU) The Ambassador meanwhile met with SDA party leader Sulejman Tihic on February 19 to impress on him the danger to the country if the legislation does not pass. Tihic at first said it could not be done without cooperation from rival Haris Silajdzic's SBiH party. When pressed, Tihic said that SDA would be "part of the solution," and would support the legislation despite risks. Later the same day, SBiH leader Silajdzic expressed similar distrust of his rival, but ultimately acknowledged that the country was on the brink of collapse. The two are meeting with Croat party leaders Dragan Covic and Bozo Ljubic on February 23, along with the World Bank and IMF resident representatives and High Representative Valentin Inzko to try to hammer out an

agreement. (Croat parties seems fine with voting for the reforms since their constituencies stand to lose less.) They then plan to convey that agreement to Parliament the following day, in hope of passage of the reforms.

Comment

¶15. (C) Passing the legislation to reform social benefits is politically difficult for Bosniak politicians (particularly SDA and SBiH) -- some have called it political suicide -- but they set themselves up for this crisis. As a manifestation of the lack of political courage exhibited so far, Federation PM Mujezinovic even called the HiRep privately to ask him to impose the needed legislation (an impossibility, of course). Passing the legislation is the only course right now that will avert economic freefall and intensified inter-entity tension. For the RS to lose \$280 million in budget support simply because of the Federation's inability to manage its own affairs hands Dodik a potent weapon in making the case for more entity autonomy.

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